American Council for Capital Formation
Center for Policy Research

March 1990

SPECIAL REPORT

Why America Won't Save

by Frank Levy and Richard Michel

In conjunction with its project exploring the causes and consequences of the low U.S. saving rate and policy options to reverse this situation, the ACCF Center for Policy Research offers this Special Report *on the issue of U.S. saving.*

This article first appeared in the Washington Post *("Outlook Section," February 4, 1990).*

"We need to save more," said President Bush in his State of the Union message and he offered a modest "Family Savings Plan," along with his trademark capital-gains tax cut, to foster that result. But the president's plan is likely to be no more effectual than his predecessor's more generous tax and savings incentives because it fails to address the clash of cultural and economic forces at the heart of our savings problem. Specifically, a high-consumption mentality, born of the boom times of the 1950s and 1960s, has carried forward into a period in which limited economic mobility has become the reality for many Americans.

For more than a decade, Americans have been saving at rates low enough to cheat our future. The personal savings rate has recently staged a small recovery, but the national savings rate—persons, business and the government combined—remains at 13 percent of GNP. In the 1950s and 1960s, we saved 16 percent of GNP and international competition has sharply increased our capital needs since then.

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Will a tax incentive do the trick? The answer depends on why savings declined in the first place. The standard story—savings were depressed by all those baby-boomers in their young, high-spending years—is wrong. It does not explain why young families today save less than the young families of 25 years ago. And it says nothing about the growth of the federal budget deficit which now reduces the national savings rate by one-sixth. A better explanation comes from what we can call the curse of the comfort zone.

The story begins 17 years ago when culture and the economy first collided. From World War II through the early 1970s, the U.S. economy grew at a remarkable pace. Average family income doubled from $16,000 to $33,000 (all figures are in today's dollars). To the man in the street, rapid growth meant rapid upward mobility. The proportion of the U.S. population in poverty fell from 32 percent in 1949 to 15 percent in 1970 without substantial redistribution. The proportion of families who owned their homes rose from 43 percent to 63 percent. The middle class was growing rapidly not because incomes were becoming much more equal (they weren't) but because incomes were growing and more families could afford a middle-class life.

Rapid growth stopped in 1973. It fell victim to OPEC oil price increases and a sudden slowdown in the growth of labor productivity—what we now call the competitiveness problem. In 1987, the income of the average family stood at $33,500, a gain of only $500 over 15 years.

In an earlier time, slower growth might have been a signal to consume less and save more. But a quarter-century of fast growth had brought the curse of the comfort zone: The belief that we had solved the problem of production and the economy no longer needed constant tending. A small example: In the early 1970s, only half of male college freshmen said "making a lot of money" was very important in their lives (80 percent say so today). Altruism aside, these freshmen *knew* they would outearn their parents no matter what jobs they took. Economic experts implicitly agreed. Their forecasts kept predicting growth would rebound.

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At first glance, this neat story does not square with the data. Department of Commerce statistics say that the personal savings rate held steady in the 1970s and declined sharply in the early 1980s, well after stagnation had set in. But the Department of Commerce defines "personal savings" as the sum of two kinds of money: individuals' discretionary savings and employer payments to employee pension funds. Brookings economist Barry Bosworth has shown that employers in the late 1970s were bringing pension fund reserves into line with the requirements of the new ERISA legislation. As a result, their pension payments were abnormally high. When these payments are removed from the official data, the savings rate of individuals begins to decline in about 1975.

The reluctance to save came at a particularly bad time. Through the 1950s and 1960s, rapid growth reflected adequate investment combined with innovations developed in the 1930s and 1940s: jet propulsion, television, synthetic materials, improved food processing. By the early 1970s, many of these innovations had run their course; they no longer provided a steady stimulus for productivity gain. Continued rapid growth would have required higher savings and investment, the opposite of what occurred.

Sociologist David Reisman saw the problem in a prescient 1969 quote: "Contrary to what I once thought, the economy is not self-propelling. We can see in the United Kingdom the problems that arise when a society becomes psychologically postindustrial long before the economic infrastructure is sound enough to bear the weight of steadily rising expectations."

By 1981, the reluctance to save had spread to the federal budget. No one likes a deficit, but the budget deficit's component parts—big tax cuts and the retention of most programs—had broad political support because they kept consumption growing. The budget deficit further lowered the national savings rate. And by opening the door for the trade deficit, it undercut mobility in a particularly focused way.

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The shift in mobility patterns during the 1980s is striking. Between 1979 and 1987, the average income of 30-year-old college-educated men rose slightly from $28,500 to $29,900. But the average income of 30-year-old high school-educated men fell from $24,200 to $19,900. The declining incomes of younger high school men reflected declining demand for their skills, a casualty of the trade deficit and its impact on manufacturing employment.

In assembling these facts, we begin to see one version of the future. If 1980–88 growth rates continue, today's typical 30-year-old man with four years of college will have peak earnings of $46,200 (today's dollars), $2,100 more than his college-educated father's best year. Today's 30-year-old man with four years of high school will reach a peak of $26,300, $3,200 *less* than his father's best year. Taken together, these young men and their families will reach retirement with an average net wealth about half of what their parents can expect to have.

Sons replicating fathers (or falling a little short) sounds more like a class system than the American Dream. In a world of limited mobility, few people make big economic gains over their lives. More feel the threat of sliding down the economic scale. People scramble for individual advantage and public purpose becomes increasingly suspect. The government faces a permanent taxpayers' revolt in which Martian exploration, research and development, and aid to the poor join a growing list of luxuries we cannot afford.

This is not a pretty picture, but it helps to explain the two obstacles to higher savings. First, the costs of slow growth have, so far, proceeded from the bottom up. College graduates gained from the trade deficit through cheap Toyotas and Sonys. But young male high school graduates lost substantial income and high-school dropouts lost still more. If an inadequate savings rate had threatened the incomes of talk show hosts and editorial writers, the deficit would have taken on a much greater urgency.

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The other obstacle to change is the economy's remarkable ability to function as smoothly in decline as in growth. For most of the 20th century, economic troubles have centered on inflation and unemployment, both of which provide good visuals for the evening news. The inadequate savings problem is equally serious, but it produces no great

fireworks and so can be ignored. Incomes grow slowly, we continue to borrow from abroad to supplement consumption, interest rates stay high to attract foreign capital, domestic investment (in both production and people) remains too low—and so incomes continue to grow slowly. Limited economic mobility becomes a fact of life.

The savings story then, is less about tax incentives than about culture, a culture that bombards us with messages to buy things—to not save—every day. In this context, the key to increased savings is a change in national outlook. A utopian thought?

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Hardly. Within recent memory, the national outlook has changed on cigarette smoking, the seriousness of drunk driving, physical exercise, casual sex (we've been through two reversals on this one), and diet. Think of undersaving as cholesterol: Both are the by-product of immediate gratification, neither involves short-run cost, both accrue slowly with real dangers in the future.

To complete the analogy, we need a public information campaign that talks about inadequate savings as plainly as we talk about cholesterol. If the president believes we are not saving enough, he should say so. But the president must also admit frankly that saving more also means that, in the short run, we must consume less. If he thinks inadequate saving helps explain our slow wage growth, or why we have to scrimp on aid to Eastern Europe, he should say so. We are ready for such a message: Almost three out of four respondents in a recent *Wall Street Journal* poll believe the Japanese economy is now stronger than ours.

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Beyond frank talk, the administration needs to publish minimum guidelines on what people *ought* to save: a simple schedule that relates annual savings to family income and age. In an ambiguous world, disinterested rules of thumb are powerful guides (there is some evidence that the limits set for Reagan-era IRA accounts acted as a guide in this way). And in a world with guidelines on everything from salt intake to safe sex, a problem without guidelines is not seen as a problem.

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Honest talk, savings guidelines and a tax incentive would almost put inadequate savings in the proper light. The only missing piece is action on the budget deficit. It is possible to construct a savings program without addressing the deficit. It is possible to lecture the nation on cholesterol while holding a pastrami sandwich. The two cases should yield roughly comparable results.

In a world of shopping malls, savings is about dull banks and passbooks. In the real world, saving is about the future. The trick is to create a future that is large enough for all of us.

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The ACCF Center for Policy Research is the education and research affiliate of the American Council for Capital Formation. Its mandate is to promote an understanding by the public of the importance of capital formation to the economy. For additional information on the Center or its saving project, please contact: ACCF Center for Policy Research, 1850 K Street, N.W., Suite 400, Washington, D.C., 20006. (202) 293-5811.